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No. 108

In the Supreme Court of the United States
October Term 1957

Commissioner of Internal Revenue, Petitioner

v.

W. F. Weed, et al

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR RESPONDENT

Peter B. Wells, Attorney
American National Bank Building
Beaumont, Texas

INDEX

Opinion below 1

Jurisdiction 1

Statutes involved 2

Question Presented 3

Statement of the case 4

Summary of Argument 7

Argument 8

1. A mineral payment is a Sec. 117 capital asset 8
2. Weed sold Munro a capital asset not a mere claim to future income 10
3. The sale of the sulphur payment by Weed to Munro was possessed of all of the elements of a bona fide transaction in substance as well as in form. 11

Conclusion 15

Cases:

Anderson v Helvering, 310 U. S. 404 9
Burnet v. Harmel, 287 U. S. 103 9
Burton-Sutton Oil Co. v. Commissioner, 328 U. S. 25 9
Caldwell v. Campbell, 218 F. (2) 567 14
Commissioner v. Hawn, 231 F. (2) 340 13
Corn Products Co v. Commissioner, 350 U. S. 46 13
Fleming v. Campbell, 205 F. (2) 549 8
Harrison v. Schaffner, 312 U. S. 579 13
Hort v. Commissioner, 313 U. S. 29 13
Lee v. Commissioner, 126 F(2) 823 8
Nail v. Commissioner, 27 BTA 33 14
Ortiz Oil Co. v. Commissioner, 112 F (2) 508 8
Sheffield v. Hogg, 124 Tex. 290 77 S. W. (2) 1021 8
Tennant, Recr. v. Dunn, 130 Tex. 285 110 S. W. 2d 53 8
Thomas v. Perkins, 301 U. S. 655 8, 9

Statutes:

Internal Revenue Code of 1939:
Sec. 22 (26 U. S. C. 1952 ed., Sec. 22) 2
Sec. 117 (26 U. S. C. 1952 ed., Sec. 117) 2

Miscellaneous:

American Law of Property (1952) Part 10, Oil and Gas Rights by Victor H. Kulp 12
Walker, **Oil Payments, Texas Law Review** Vol XX, pg. 259 (Jan. 1942) 8
Note: Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income are Sold, Harvard Law Review, Vol. 69, pg. 737 (Feb. 1956) 13
Miller, **The "Capital Asset" Concept: A Critique of Capital Gains Taxation,** 59 Yale Law Journal 837, 1057 13
Surrey, **Definitional Problems in Capital Gains Taxation,** Federal Tax Policy for Economic Growth and Stability, 401 (Joint Committee on the Economic Report, 84th Congress, 1955) 7

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W. F. Weed, Individual, and Estate of Eleanor M. Weed, Deceased, W. F. Weed, Executor, Respondents

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BRIEF FOR RESPONDENT

OPINION BELOW

The findings of facts and opinion of the Tax Court (R. 252-261) are reported at 24 T. C. 1025. The opinion of the United States Court of Appeals for the Fifth Circuit (R. 262-264) is reported at 241 F. (2d) 69.

JURISDICTION

The United States Supreme Court has jurisdiction under 28 U. S. C. sec. 1254.

The judgment of the Court of Appeals was entered February 1, 1957 (R. 265). Petition for writ of certiorari was granted by this Court June 3, 1957.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) **General Definition.** — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) DEFINITION. — As used in this chapter —

(1) (as amended by Sec. 115 (b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798) property held by the taxpayer (whether or not **Capital assets.** — The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l) * * * or real property used in the trade or business of the taxpayer.

* * * * *

(4) (as amended by Sec. 150 (a) (1) of the Revenue Act of 1952, **supra) Long-term capital gain.** — The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(b) (as amended by Sec. 150 (c) of the Revenue Act of 1942, **supra) Percentage Taken Into Account.** — In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

QUESTION PRESENTED

When the Respondent exchanged a sulphur payment for cash and note, should the proceeds of such transaction be taxed to him as capital gains (1939 Code, Sec. 117) or as ordinary income?

STATEMENT OF THE CASE

On December 23, 1947, Weed was the owner of a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land referred to as Boling Dome, in Wharton County, Texas. Weed's royalty interest entitled him to receive $.00966133 per long ton of sulphur produced from Boling Dome by the aforementioned company, irrespective of what the market price for such sulphur might be. Royalty payments were made by the company monthly, based on the previous month's production. Weed's $.00966133 per long ton interest represented the aggregate of three pooled royalty interests, each in a lesser amount, received by Weed (a) from his father by two **inter vivos** deeds dated September 1, 1933 and August 15, 1935, respectively, and (b) after his father's death, from the latter's estate by independent executor's deed dated August 1, 1945. Such interest was not held by Weed primarily for sale to customers in the ordinary course of his trade or business. (R. 254-255)

The Boling Dome tract was composed of a number of parcels of land. The owners of the royalty interests in sulphur produced from each of those individual parcels entered into a pooling agreement pursuant to which royalties from sulphur produced anywhere in Boling Dome were to be distributed pro rata among all such royalty interest holders. Thus, Weed's interest is referred to as "pooled." (R. 254)

Weed in 1947 believed that, in 1948 and the succeeding years, he would need all (or a large part) of the credit which was available to him personally at the banks or through similar sources to obtain funds for use in the carrying on of his widespread business enterprises. He, therefore, desired some assurance that

he would have a definite source of funds (other than banks and similar sources) for payment of his individual Federal income taxes due in those later years. (R. 254)

In the summer or early fall of 1947, Weed, Frank C. Taylor (a C. P. A. then retained as accountant for Weed's personal affairs and who prepared Weed's 1947 return), and Marion Munro (a C. P. A. then retained by two of Weed's Corporations and who subsequently prepared Weed's individual joint returns for 1948 and 1949) discussed the problem of Weed's business commitments and the need for providing some sure source of funds with which to pay Weed's individual income taxes, especially those due in January 1948. It was suggested that Weed might sell a portion of his Boling Dome royalty interests, and Munro expressed the opinion that such a transaction would have the advantage of being taxed to Weed at capital gain rates. Munro indicated a probable willingness to purchase a portion of that royalty interest and negotiations followed. (R. 255)

Weed and Munro discussed the amount of money Weed would probably need in later years to pay his taxes, the probable amount of sulphur still in place, (the sulphur deposit was originally estimated to have been 45,000,000 tons of which 24,000,000 tons had been produced) anticipated annual rate of sulphur production, the annual royalty payments which would probably be received by a purchaser of Weed's interest, the probable amount of time required for pay-outs from sulphur production of different sums of money, the discount factor (such as the interest Munro would have to pay on funds borrowed by him to purchase the royalty interest) which affected Munro's profit from the transaction, and the tax savings to Weed. (R. 255)

It was finally agreed that the transaction would be based upon Weed's anticipated requirements for funds

to pay taxes for the succeeding three years, and upon a four-year pay-out period from sulphur production to Munro. On this basis, it was determined that Weed would assign to Munro a portion of his royalty interest on 6,000,000 long tons of sulphur, from which Munro would receive $50,000 within about four years, and that, in return, Munro would pay Weed $13,900 cash and give Weed two notes of $16,300 each, one due in one year and the other in two years. It was necessary for Munro to borrow a portion of the cash required.

Munro's loans from the bank were negotiated by him independently of Weed and not guaranteed by Weed. As security for the loans Munro assigned to the bank the royalty interest purchased from Weed until such time as all his loans were paid. Concurrently with that assignment he notified the Texas Gulf Sulphur Company to make his royalty checks payable jointly to himself and the bank and to mail them directly to the bank. The bank credited the royalty checks received first to the principal and interest due on the above loans and, when that was satisfied, to Munro's personal account. Receipt of royalty checks from Texas Gulf Sulphur Company averaging about $2,000 each from February 28, 1948 until March 20, 1950 (on which date the limited royalty interest on 6,000,000 tons was fully paid out) resulted in its being unnecessary for Munro to borrow more than $11,500 in order to meet the two $16,300 notes due Weed since Munro was able to, in part, pay those notes at maturity with royalties received and accumulated prior thereto. (R. 257).

As above indicated, the limited royalty interest which Weed assigned Munro on December 24, 1947, was paid out within 28 months thereafter. In his income tax returns Munro reported the royalties he received as ordinary income, less cost depletion, in the year of receipt.

Weed used the $13,900 received from Munro on December 24, 1947, in paying the January 15, 1948 installment on his 1947 Federal income tax. (R. 257).

The taxpayer disclosed the transaction fully in his 1947 tax return, treating the proceeds as capital gains and reporting the profits on the installment basis. Taxpayer's 1948 and 1949 returns reported the $16,300 received from Munro for each such year as long term capital gain. The Commissioner determined that the 1948 and 1949 payments were taxable as ordinary income, subject to depletion. The Tax Court held these proceeds were realized from the sale of a sulphur payment and constituted capital gain. This view was affirmed by the Court of Appeals. (R. 258).

SUMMARY OF ARGUMENT

Sec. 117 (a) (4) of the Internal Revenue Code of 1939 defines long term capital as the "gain from the sale or exchange of a capital asset held for more than 6 months—," and Sec. 117 (a) (1) defines "capital assets" as "property held by the taxpayer" with certain exclusions. These definitions were not substantially changed in the 1954 Code.[1]

Thus, the proceeds from the sale of property (held by the taxpayer for more than six months) are entitled to capital gains treatment unless the transaction or the property falls within the exclusions provided by law.

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[1] Surrey, **Definitional Problems in Capital Gains Taxation.** Federal Tax Policy for Economic Growth and Stability, 404. (Joint Committee on the Economic Report, 84th Congress, 1955.)

Respondent contends a sulphur payment is property and that its sale is not excluded from capital gains treatment; respondent further contends that the Weed-Munro transaction, at issue here, had substance in fact and in law, and being the sale of a capital asset held for six months and not the anticipation of future income was entitled to capital gains treatment.

* * * * *

ARGUMENT

1. A MINERAL PAYMENT IS A SEC. 117 CAPITAL ASSET.

Petitioner's brief concedes, as indeed it must, that a mineral payment is property, the Texas courts have determined that mineral payment rights in Texas are real property interests,[2] but contends that the sale of a "carved-out" mineral payment constituted the assignment

[2] Sheffield v. Hogg, 124 Tex 290, 77 S. W. (2) 1021; Tennant v. Dunn, 130 Tex. 285., 110 S. W. (2) 53. See also A. W. Walker, Jr., Oil Payments, 20 Tex. Law Review pp. 259, et seq. (Jan. 1942). That view has been consistently held by the Texas Courts, appropriate United States Court of Appeals, and the United States Supreme Court which in Thomas v. Perkins, 301 U. S. 655 (1937) determined the nature of an oil payment for income tax purposes and established the rule that an oil payment is an economic interest in the mineral in place even though the payment is to be made in money.

This view expressed by the United States Supreme Court has never been changed and in fact was adopted by the Commissioner of Internal Revenue and urged upon the United States Court of Appeals in Ortiz Oil Co. v. Commissioner, 102 Fed. (2) 508; Cert. denied, 308 U. S. 566.

See also: Lee v. Commissioner, 126 Fed. (2) 825 (1942)
Fleming v. Campbell, 205 Fed. (2) 549 (1953)

of future income. Such a position ignores the essential difference between the property itself and the relationship arising when that property is placed into the channels of commerce.

In the ground mineral deposits are a part of the real estate, minerals produced from these deposits are personal property; but the fact that the deposit may some day be produced and may some day become personal property does not thereby convert such unproduced mineral deposit into the thing it may become.

The distinction between (1) an economic interest in the mineral in place and (2) the right to future income has been employed by this court in **Burnet v. Harmel,** 287 U. S. 103, **Thomas v. Perkins** 301 U. S. 655; **Anderson v. Helvernig,** 310 U. S. 404; and **Burton-Sutton Oil Co. v. Commissioner,** 328 U. S. 25 to point up the difference between a capital asset (on which depletion may be taken) and the proceeds or income therefrom. The fact that minerals may be produced at a future date does not convert their sale (while yet unproduced and in the ground) into the sale of produced minerals; nor does the sale of such economic interest of the minerals in place result in the realization of the future income which may result from the production of the minerals.

When the vendor parts with all of his economic interest in the minerals in place, he sells a capital asset and is entitled to treat the proceeds as capital gains. The vendor of a mineral payment conveys to the purchaser all of his interest in those certain tons or barrels of minerals. Further when the owner of a parcel of land conveys to a purchaser an undivided one-half interest in the North one-half of that parcel, no one has been heard to say that the vendor sells anything less than a capital asset just because he retains all of the

South one-half of the parcel and an undivided half of the North half.

And so it is with "carving-out" a mineral payment — the vendor sells all of his interest in an undivided fraction (as measured by a specific number of tons or barrels) of the mineral in place; he retains no economic interest in the sold minerals, he has no reversion therein, and he has no control thereover, this is the sale of property, not the realization of future income.

The owner of a sulphur royalty has an economic interest in the sulphur in place. It is true that the ordinary sulphur lease provides that the sulphur royalty holder is to be paid a specific sum in dollars or cents for each ton of sulphur produced (rather than a fraction of each barrel of oil in the usual oil lease), but this does not alter the nature of his economic interest in the sulphur in place, and when the owner of the sulphur royalty sells a fraction of that royalty or carves a sulphur payment out of it, he usually describes the conveyed interest as being so many cents per ton of sulphur produced (or so many cents per ton out of so many tons of sulphur produced).

Therefore, when Weed sold Munro a sulphur payment, Weed sold and Munro acquired a depletable property, a fractional interest in certain sulphur in place in the Boling Dome; and Weed reported the proceeds of that sale as capital gains.

2. WEED SOLD MUNRO A CAPITAL ASSET NOT A MERE CLAIM TO FUTURE INCOME

When Munro acquired the sulphur payment from Weed, he took that property subject to all of the risks, rights and benefits of ownership of property of that nature. As the owner of that mineral property, he was entitled to depletion when the minerals were produced. **Thomas**

v. Perkins, supra. Munro owned his interest in that sulphur whether it was produced or not, and he had all of rights which Weed had previously owned in the conveyed sulphur. Munro did not realize income from the sulphur until it was produced; Weed realized his gain from the transaction when he sold the property to Munro (an installment sale under Sec. 44), he had no continuing right or interest in the income realized therefrom by Munro. Had Weed sold Munro a rent house, Munro would have realized ordinary income when he received the rents from the house, but the purchaser's right to the rents does not convert the sale transaction into the realization of future income by the vendor.

In order for the income proceeds from the property to be taxed to the vendor, the transaction must lack substantiality.

3. THE SALE OF THE SULPHUR PAYMENT BY WEED TO MUNRO WAS POSSESSED OF ALL OF THE ELEMENTS OF A BONAFIDE TRANSACTION IN SUBSTANCE AS WELL AS IN FORM.

The Tax Court has already found that the Weed-Munro sale was bona fide (R. 260), and this has been affirmed by the Court of Appeals. Weed had a definite business purpose for selling the sulphur payment; he was the financier of several corporations which were in need of funds and which did not have adequate credit of their own. It was necessary that such funds be furnished, either directly or through endorsement, by taxpayer; and in addition the taxpayer was contemplating entering other businesses and promoting a patent at this time. He did not have sufficient ready cash to pay the federal income tax payment due January 15, 1948 and he decided to provide definite, certain cash for such tax obligations. Actually, the taxpayer did use the proceeds from the sale to Munro to make the tax payment. As a matter

of sound business judgement, taxpayer elected to raise the required cash by sale of this asset — a portion of his sulphur royalty

And the sale of the sulphur payment was actually negotiated in an arm's-length negotiation between Weed and Munro, who secured the funds to pay Weed by an independent bank loan, without aid or endorsement by Weed, and who reported the income from the sulphur payment as ordinary income subject to depletion.

Determination of the nature of the thing sold also adds to the substantialness of the transaction. As a solid in the ground, sulphur ore does not have those qualities which have caused some jurisdictions to apply the doctrine of "capture" to oil and gas operations. Thus, the sale of a sulphur interest may be more comparable to the sale of a coal interest than to the sale of an oil interest.[3]

Contention has been made that the sulphur sale is insubstantial because Weed sold less than all he owned. Weed sold to Munro approximately 86% of his interest in six million tons of sulphur. At the time of the sale Weed's estimates (and on which his dealings with Munro were predicated) showed a remaining sulphur reserve in

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[3] American Law of Property (1952), Part 10, Oil and Gas Rights by Victor H. Kulp, See sections 10.4 and 10.5.

Sec. 117k (2) of the 1939 Internal Revenue Code indicates capital gain treatment of coal sales comparable to the sulphur interest sale here. Certainly statutory provision for coal does not per se include sulphur also but note that GCM 24849 and I. T. 4003, in determining that sales of oil payments may produce ordinary income, use the expression "oil and gas" and omit "and other minerals", so by the same token we may assume that the Commissioner had not intended or had not manifested any intention to treat as ordinary income the proceeds from the sale of sulphur payments.

the Boling Dome field of between eighteen and twenty-one million tons Thus Weed sold 86% of six-twenty-firsts of the estimated remaining reserve, or almost one-fourth of the remaining reserve; this we believe is substantial.

Weed and Munro estimated a four year pay out, yet actually the six million tons were produced in twenty-eight months, and this was due to unusually great production in 1948, which could not have been anticipated by the parties.

A recent and interesting Harvard Law Review note[4] suggests the use of "risks" to determine whether or not a transfer of an oil payment results in ordinary income or capital gain; thus, if a "substantial risk" has been transferred to the buyer, the seller's proceeds are taxed as capital gains.

Here, Munro certainly undertook risk, a decline in Boling Dome sulphur production for any number of reasons would have resulted in loss to Munro. Munro had no guarantee or cushion of interest payments. Weed had no part in Munro's procurement of funds with which to pay Weed, and Munro had no promise from Weed to pay any excess interest charges.

It must recognized that taxpayers may, and have assigned income and employed the form of capital gain transactions without actually and substantially selling a capital asset.[5] Because a wise and proper tax method or

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[4] 69 Harvard Law Review 737, at pages 743, 745 (February 1956) "Distinguishing Ordinary Income From Capital Gain Where Rights to Future Income are Sold."

[5] **Hort v. Commissioner,** 313 U. S. 29
Harrison v. Schaffner, 312 U. S. 579
Corn Products Co. v. Commissioner, 350 U. S. 46 (1955)
Miller, **The "Capital Asset" Concept: A Critique of Capital Gains Taxations,** 59 Yale Law Journal, 837, 1057.

procedure may be improperly employed or subjected to sham transactions does not warrant judicial abolition of the arrangement. Rather, it would appear to be the function of the judiciary to examine those cases of "form over substance" and having determined the bona fides of the transaction, reject the sham. Such has been the practice of the court below which rejected the device employed in **Commissioner v. Hawn,** 231 F (2) 340 as being insubstantial in contrast with its holding in Caldwell v. Campbell, 218 F (2) 340.

Respondent here believes that Court has indicated the proper approach to a solution of the whole problem of the sale of mineral payments when the transaction is an obvious sham, a mere device for diverting income or avoiding tax and lacks the substance of a bona fide sale, the court should set aside the whole transaction and tax the income as it was actually realized.

The solution does not lie in the promulgation of administrative determinations issued after reliance has been had on an accepted method of operation. For many years mineral operations have been financed by the sale of mineral payments, those were generally conceded to result in the realization of capital gains to the seller,[6] when in 1946 G. C. M. 24849 (C. B. 1946-1,66) was issued. It stated that the consideration received for the assignment of short lived (one or two years) oil payment carved out of a depletable interest would constitute ordinary income. It is to be noted that this G. C. M.'s application is limited to **oil and gas** payments (it does not cover the other minerals) which expire within one or two years.

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[6] **Nail v. Commissioner,** 27BTA33

G. C. M. 24849 had been issued, prior to the Weed-Munro transaction, and represented the Internal Revenue position at that time. **After** the Weed-Munro transaction I. T. 4003 (C. B. 1950-1-p-10) was issued. It stated the assignment of carved-out oil and gas payments (not pledged for development, etc.) would result in ordinary income to the assignor. Again this did not include "other minerals".

It is submitted that G. C. M. 24849 and I. T. 4003 do not apply to the Weed-Munro sale of a **sulphur** payment in 1946 which was contemplated to require four years for pay-out.

Respondent submits that the sale of the sulphur payment from Weed to Munro was made for a business purpose and it has been determined by the Tax Court (and sustained by the Court of Appeals) to constitute a bona fide transaction. The combined pay-out period exceeded the definition of short term payments theretofore employed by the Commissioner of Internal Revenue, and the sale of the sulphur payment was the sale of a capital asset and entitled to capital gains treatment, under Sec. 117.

CONCLUSION

It is respectfully submitted that the judgment below should be affirmed

PETER B. WELLS
Attorney for Respondent

American National Bank Building
Beaumont, Texas

February, 1958